

Factoring arrangements in the United Arab Emirates

Patrick Slater - Senior Associate - Banking and Finance
- Abu Dhabi

Ashish Banga - Senior Associate - Consultant - Banking and Finance
a.banga@tamimi.com - Abu Dhabi

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It is a financing arrangement that enables a business to sell its account receivables (ie. outstanding monies owed to that business) to third parties at a discounted price. These third parties are typically banks or financial institutions, also known as factors. A company would agree to sell and assign its receivables to the factor, prior to their due date, at an agreed discounted rate. The discount accounts for the risk of non-payment.

Factoring Arrangements

a. Recourse Factoring

The most common form of factoring arrangement across most jurisdictions is a recourse factoring arrangement. In a recourse factoring arrangement, the company shall be obliged to re-purchase the receivables in the event that the purchaser of the goods or services, which have been validly assigned to the factor, does not make payment to the factor.

b. Non Recourse Factoring

The alternative arrangement is non recourse factoring where the only recourse available to factors for non-payment is against the purchasers themselves (except in specific circumstances such as situations involving a commercial dispute between the company and the purchaser). We set out some of these circumstances in the section below dealing with the most common risks faced by clients.

More specific to this region is an undisclosed factoring arrangement, which factors may agree to, but this depends upon the nature of the purchaser.

c. Undisclosed Factoring

Where the purchasers are highly rated but there are difficulties in obtaining acknowledgments from them, the factoring arrangement may remain undisclosed to the purchaser and it is only the company who has resort against the purchaser. In these cases, in the event of non payment and exercising recourse against the purchaser, the company acts as the agent of the factor.

Legal Requirements

a. Assignment of receivables

- Assignment of receivables is a concept recognised under the published and gazetted laws of the United Arab Emirates ("UAE Law") subject to certain conditions. Assignment of a future receivable, over any asset that is not identifiable or where the identification is uncertain, will not be recognised under the UAE Law. Therefore, the invoices that evidence any receivable to be assigned should have already been

issued by the company.

- The subject matter of the assignment should be free from encumbrances and other restrictions. In the event that the underlying sale and purchase contract contains such prohibitions or conditions, such prohibitions or conditions must be waived by the purchaser.

b. Perfection

- The jurisprudence in relation to perfection of assignment of receivables differs between Emirates. Under UAE Law as applied by the courts of the Emirate of Dubai, for an assignment of rights to be perfected, written notice advising of the assignment must have been received by the relevant counterparty. Under UAE Law as applied by the federal courts of the United Arab Emirates (the “Federal Courts”), for an assignment of rights to be perfected it must be received by the relevant counterparty and that counterparty must consent to the assignment. There seems to have been a shift whereby a notice of the assignment in some cases has been deemed sufficient by the Federal Courts to perfect an assignment without the need for an acknowledgment or consent, but this is not a sufficiently established practice to alter legal advice as to the legal requirements.
- Whilst each assignment is effective as between a factor and a company from the date on which it was entered into (assuming the company had capacity and authority and had duly executed such assignment), the perfection requirements are relevant to the factor’s rights against the purchaser, since these are not available until perfection of the assignment.

Risk Factors Applicable to Factoring Arrangements

a. Perfection

As stated above, within the Emirate of Dubai, perfection requires notice and for the Emirates which follow the Federal Court system perfection requires consent and acknowledgment.

An undisclosed factoring arrangement, by its very nature, is not perfected so affords no rights to the factor against the purchaser.

UAE Law requires the party receiving the assets or rights, pursuant to any sale or transfer of assets or rights, to take possession of or control over those assets or rights to complete the sale or transfer. In a recourse or non recourse factoring arrangement, this requirement shall be fulfilled by way of an instruction under the notice of assignment (addressed to the purchaser by the company), that the assigned receivables will be deposited in the factor’s designated account. In an undisclosed factoring arrangement, where no notice was served to the purchaser, the requirement of possession may be achieved by the company collecting the assigned receivables on behalf of the factor as its agent and obliging the company to pay the collected receivables into a blocked account held with the factor.

Whilst such an agency arrangement should be sufficient to achieve constructive possession of the receivables by the factor, there is little clarity because:

- such a structure has not been tested before the Courts of the United Arab Emirates; and
- the assignment under an undisclosed factoring arrangement is never perfected, as mentioned above.

b. Insolvency of the Company

i. Priority of claims

In a recourse factoring arrangement, the factor is not taking a risk on the creditworthiness of the purchaser unless the company becomes insolvent, whereas in a non recourse factoring arrangement, the factor takes a risk on the creditworthiness of the Purchaser. This potentially makes a non recourse factoring arrangement more expensive.

Under an undisclosed factoring arrangement, it is highly likely that the receivables will form part of the insolvent company's pool of assets as the assignment has not been perfected. In this case, the factor is taking a credit risk on the company. For disclosed factoring if there has been a perfected assignment the receivables do not form part of the insolvent company's assets so the factor is not taking is no credit risk on the company.

ii. Antecedent transactions

There are certain circumstances in which transactions effected by an insolvent party can be challenged. The applicable provisions of Federal Law No. 18 of 1993 issuing the Commercial Transactions Law (the "UAE Commercial Code") provide for a two year claw-back period (ending on the date of insolvency) in respect of the following types of payments made, or security granted, by the insolvent party:

- donations;
- amounts paid to settle a debt before the maturity of its term;
- settlement of a debt in a manner otherwise than as agreed (ie. by payment in kind);
- provision of a mortgage or other security over the debtors property to secure a prior debt; and
- any other disposal by the insolvent party during the claw-back period which harms its general body of creditors.

Such disposals may also include sale of receivables for consideration which may be lower than market value. There appears to be no specific test set out under the UAE Law regarding the value of the consideration for the sale of receivables and this would be a matter for the discretion of the Federal Courts and the local courts of each Emirate in the UAE. Any sale or transfer deemed to be below market value by a court of the UAE could be subject to challenge in insolvency.

c. Prior assignment or encumbrance

There is no independent public register in the UAE, which registers the documentation in relation to factoring arrangements or any assignment of receivables. In the event that a competing assignment arises or is claimed, then enforcement would depend on the dates of the notices or acknowledgements of each of the competing assignments, with the first assignment to be properly perfected being effective.

Therefore, an assignment under a recourse or non recourse factoring arrangement may still be effective if perfected first in time (against a competing interest) as against an assignment under an undisclosed factoring arrangement, which is never perfected.

d. Dispute between the Company and the Purchaser in relation to underlying sale contract

As the factor will be subject to: (i) the terms of the underlying sale and purchase contract; and (ii) the conduct between the company and the purchaser, in relation to the goods or services to be provided, the factor should conduct proper due diligence into the company's business and history with regard to recovery of receivables, issues with quality, disputes and any other due diligence as the factor may consider relevant to the purchaser. Factors should carefully consider the provisions of the sale and purchase contract including provisions, which relate to prohibition on assignment or complex countervailing rights such as set off, withholding or volume rebates.

e. Power of attorney

While it is advisable for the factor to obtain a power of attorney from the company authorising its legal recourse against the purchaser for non-payment, it should be noted that in general a power of attorney in the UAE is revocable.

Some comfort can be taken from Article 955 of Federal Law No. 5 of 1985 issuing the Civil Transactions Law, which states:

“...if the agency has been created for the benefit of the agent, in which case the principal may not terminate or restrict it without the consent of the person for whose benefit it was created.”

A power of attorney may also: (i) give the factor credibility when seeking payment from purchasers; and (ii) allow the factor to file a legal action and send legal notices on behalf of the company.

f. Account Provisions

All assigned receivables should be paid into the factor's account in order for it to reflect as a true sale of receivables under the relevant invoices. For regulatory reasons it is sometimes not possible or advisable for a bank to have receivables paid to an account in its name. In such situations, the receivables should be paid to a blocked or pledged account of the assignor ie. where the company is appointed as an agent of the factor.

Most Common Risks Faced by Clients

a. Retrospective discount by the Company

There are often concerns regarding retrospective discounts agreed between the company and the purchaser. This risk may be addressed in the proposed factoring agreement by way of:

- a representation by the company to the factor that the receivables are not subject to any discount; and
- a notice to the purchaser, which states that payment for assigned receivables shall be made to the factor without any deduction.

In a non recourse factoring arrangement, the factor should ensure that breach of the representation in (i) above is an event which obliges the Company to re-purchase the assigned receivables pursuant to terms of the factoring agreement between them.

b. Negation of assignment

This risk only arises under a non-recourse factoring as under a recourse factoring arrangement it would be re-purchased by the Company. Therefore any negation of assignment should be specified as a breach of the factoring agreement.

c. Violations by the Company of the agreement form with the Purchaser

It is always advisable that factors ensure that:

- any change in the underlying sale and purchase contract between the Company and the Purchaser is a non-recourse repurchase event; and
- amendment of invoices evidencing assigned receivables is prohibited without the prior consent of the factor.

d. Insolvency of the Purchaser

The risk of insolvency or bankruptcy of the purchaser may be dealt with by way of a credit insurance, entered into between the factor, as the beneficiary, and the relevant insurance company.

e. Imperfect documentation

This risk may be addressed by obligating the Company under the factoring agreement to take all such steps or actions that may be required by the factor or otherwise, to perfect assignment(s) entered into

pursuant to a factoring arrangement.

f. Disputes in relation to unidentified proceeds

Factors should ensure that the factoring agreement contains provisions allowing the factor to debit sums standing to the credit of the company account received from a purchaser unallocated, which are in the factor's reasonable opinion, the proceeds of an assigned receivable.

Factoring arrangements governed under laws other than those of the UAE

Perfection requirements may be different where agreements are governed by laws other than those of the UAE. While UAE Law recognises the principle of freedom of contract, which extends to choice of governing law and jurisdiction, the UAE Courts are usually reluctant to recognise the choice of a foreign law or jurisdiction and may apply UAE Law irrespective of the agreement between the parties. This may lead to the evidential requirement of the purchaser's acknowledgment and consent to uphold the validity of assignment, even if this would not have been required under the parties' chosen governing law. It is accordingly advisable to have assignments perfected under the laws which govern (i) the underlying commercial agreements or (ii) the jurisdiction of the company or purchaser.

Conclusion

While factors may not always have the choice of their preferred form of factoring arrangement, in the UAE, undisclosed factoring arrangements are inadvisable unless the factor is given confirmation from the purchaser that it will not consent to or acknowledge such an arrangement.